

**BEFORE
SOUTH CAROLINA PUBLIC SERVICE COMMISSION**

DOCKET NO. 2012-218-E

In the Matter of:

Application of South Carolina Electric & Gas Company)	
For Increases and Adjustments in Electric Rate)	Docket No. 2012-218-E
Schedules and Tariffs and Request for Mid-Period)	
Reduction in Base Rates for Fuel)	

Direct Testimony

of

Kevin W. O'Donnell, CFA

On Behalf of

South Carolina Energy Users Committee

October 26, 2012

**BEFORE
SOUTH CAROLINA PUBLIC SERVICE COMMISSION
DIRECT TESTIMONY OF KEVIN W. O'DONNELL, CFA**

1 **Q. PLEASE STATE YOUR NAME, POSITION, AND BUSINESS ADDRESS FOR**
2 **THE RECORD.**

3 A. My name is Kevin W. O'Donnell. I am President of Nova Energy Consultants, Inc. My
4 business address is 1350 Maynard Rd., Suite 101, Cary, North Carolina 27511.

6 **Q. ON WHOSE BEHALF ARE YOU PRESENTING TESTIMONY IN THIS**
7 **PROCEEDING?**

8 A. I am testifying on behalf of South Carolina Energy Users Committee (SCEUC), which is
9 an industrial trade association in South Carolina. Many of SCEUC's members take retail
10 electric service from South Carolina Electric & Gas (SCE&G or the Company) and will
11 be impacted by the proceedings in this case.

13 **Q. PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND AND**
14 **RELEVANT EMPLOYMENT EXPERIENCE.**

15 A. I have a Bachelor of Science in Civil Engineering from North Carolina State University
16 and a Master of Business Administration from the Florida State University. I have
17 worked in utility regulation since September 1984, when I joined the Public Staff of the
18 North Carolina Utilities Commission (NCUC). I left the NCUC Public Staff in 1991 and
19 have worked continuously in utility consulting since that time, first with Booth &
20 Associates, Inc. (until 1994), then as Director of Retail Rates for the North Carolina
21 Electric Membership Corporation (1994-1995), and since then in my own consulting
22 firm. I have been accepted as an expert witness on rate of return, cost of capital, capital
23 structure, cost of service, and other regulatory issues in general rate cases, fuel cost
24 proceedings, and other proceedings before the North Carolina Utilities Commission, the
25 South Carolina Public Service Commission (SC PSC), the Virginia State Commerce

1 Commission, the Minnesota Public Service Commission (MPSC), and the Florida Public
2 Service Commission (FL PSC). In 1996, I testified before the U.S. House of
3 Representatives, Committee on Commerce and Subcommittee on Energy and Power,
4 concerning competition within the electric utility industry. Additional details regarding
5 my education and work experience are set forth in Appendix A to my direct testimony.
6

7 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?**

8 A. The purpose of my testimony in this proceeding is to present to the Commission my
9 findings as to the proper return on equity and capital structure for use in this proceeding
10 as well as to address adjustments to certain revenue requirements and rate design issues.
11

12
13 **Q. PLEASE SUMMARIZE YOUR PRIMARY RECOMMENDATIONS IN THIS CASE.**
14

15 A. My recommendations in this case are as follows:

- 16 • the proper return on equity on which to set rates for SCE&G in this proceeding is
17 9.50%;
- 18 • the proper capital structure to use in this proceeding is the SCANA Corporation
19 (SCANA) capital structure as of June 30, 2012;
- 20 • the return on equity recommended by Company Witness Hevert is excessive and
21 unreasonable;
- 22 • the Company should bear 50% of the revenue loss associated with the net loss
23 associated with the terminated wholesale power contract;
- 24 • all employee incentive pay should be eliminated;
- 25 • the Company should not be allowed recovery of EEI dues;
- 26 • SCE&G's request for placing the pension deferral in rate base should be
27 disallowed; and
- 28 • the Company's request for additions to its storm reserve fund should be
29 disallowed.
30

1
2 **Q. HOW IS YOUR TESTIMONY STRUCTURED?**

3 A. My testimony is divided into nine sections as follows:

4 I. Comparison of SCE&G's Rates to Other Southeastern US Electric Utilities

5 II. Economic and Regulatory Policy Guidelines for A Fair Rate of Return

6 III. Common Equity

7 A. DCF Analysis

8 B. Comparable Earnings Analysis

9 C. Return on Equity Recommendation

10 D. Capital Structure

11 E. Review of Company Witness Hevert's Testimony

12 IV. Accounting Adjustments

13 V. Cost of Service Study and Rate Design

14 VI. Fuel Reduction

15 VII. Summary
16
17

I. COMPARISON OF SCE&G RATES TO OTHER SOUTHEASTERN US ELECTRIC UTILITIES

Q. MR. O'DONNELL, HOW DO THE ELECTRIC RATES FOR INDUSTRIAL SERVICE OF SCE&G COMPARE TO OTHER INVESTOR-OWNED ELECTRIC UTILITIES IN THE CAROLINAS AND GEORGIA.

A. Unfortunately, in comparison to other large electric investor-owned utilities located in the Southeast, SCE&G has the highest industrial rates in the region. A comparison of the average industrial electric costs for investor-owned utilities in the Carolinas and Georgia can be seen in Table 1 below.

Table 1: Comparison of Average Industrial Costs

**Average Industrial Electric Costs
Raw Data from Energy Information Administration - 2011**

Entity	State	Average Retail Price (cents/kWh)
Virginia Electric & Power Co	NC	4.81
Duke Energy Carolinas, LLC	SC	4.81
Duke Energy Carolinas, LLC	NC	5.34
Progress Energy Carolinas Inc	SC	6.12
Georgia Power Co	GA	6.58
Progress Energy Carolinas Inc	NC	6.62
South Carolina Electric & Gas Co	SC	6.95

1 **Q. HOW DO THE HIGH SCE&G ELECTRIC RATES AFFECT ECONOMIC**
2 **DEVELOPMENT AND JOB RETENTION IN THE COMPANY'S SERVICE**
3 **TERRITORY?**

4 A. In his direct prefiled testimony, Mr. Stephen Byrne of the Company suggests what he
5 believes is strong industrial development and Southern and Central South Carolina. To be
6 specific, Mr. Byrne states:

7
8 It (map showing industrial development) shows that in spite of the current
9 financial difficulties, South Carolina is clearly emerging as a leading site for
10 manufacturing expansion. South Carolina has become a center for investment in
11 aerospace manufacturing, tire manufacturing, and automotive manufacturing. As
12 the nation emerges from the recession, we expect the pace of manufacturing
13 investment in South Carolina to increase. Because of our planned investment in a
14 balanced generation portfolio, SCE&G can show very attractive long-term
15 opportunities to industrial prospects and ample supplies of low-emission
16 generation. We can show them that by locating on our system, they can receive
17 electric service from a system that, in the not so distant future, will generate 60%
18 of its energy from sources that do not emit carbon. This means that by locating
19 here, businesses can potentially reduce their long-term exposure to carbon taxes
20 or regulation. We can show businesses that by 2015, our plan is for all of
21 SCE&G's coal generation to be fitted with scrubbers and SCRs. This means that
22 by locating here or expanding here, businesses can reduce their risk of exposure
23 to costly new regulations on SO₂, NO_x or mercury emissions. We can show
24 businesses that in 2019, no single fossil fuel source will represent more than 28%
25 of our generation capacity. By locating or expanding here, businesses can
26 minimize their risk from exposure to future price volatility of or supply and
27 delivery problems with natural gas or coal.
28

29 Unfortunately for South Carolina, nowhere in the above comments is any discussion
30 about the cost of electricity provided by SCE&G. The obvious reason is that SCE&G's
31 rates simply do not compare well with other areas of the country, and that distinction will
32 drive away economic development in South Carolina unless other economic development
33 measures are enhanced to offset this deterrent to increased investment in SCE&G's
34 service territory. However, such enhanced economic development tools are generally not
35 applicable to existing industrial customers which must bear the increased cost without
36 any assistance.
37

Q. HOW DO SCE&G'S RESIDENTIAL RATES COMPARE TO OTHER INVESTOR-OWNED ELECTRIC UTILITIES IN THE SOUTHEAST?

A. As is the case with industrial rates, SCE&G's residential rates are high in comparison to other utilities in the Carolinas and Georgia. In Table 2 below, I compared the average SCE&G residential cost to other investor-owned utilities in North Carolina, South Carolina, and Georgia.

Table 2: Comparison of Average Residential Costs

Average Residential Electric Rates
Raw Data from Energy Information Administration - 2011

Entity	State	Average Retail Price (cents/kWh)
Duke Energy Carolinas, LLC	SC	9.07
Duke Energy Carolinas, LLC	NC	9.15
Virginia Electric & Power Co	NC	9.22
Progress Energy Carolinas Inc	SC	9.86
Progress Energy Carolinas Inc	NC	10.12
Georgia Power Co	GA	11.90
South Carolina Electric & Gas Co	SC	12.51

Although it may be difficult for the Company to admit, SCE&G is a high cost electric utility in comparison to its neighboring investor-owned electric utilities. Given the fact that the Company is seeking a rate increase in this case coupled with the expected annual increases associated with the Base Load Review Act (BLRA), SCE&G's position relative to other nearby utilities is likely to get worse in the next 5-years. SCE&G risks the continuing loss of manufacturing customers that will either close down, move their operations, or choose to self-generate. With natural gas at historically low levels, the economics of self-generation has improved and many large industrial consumers will evaluate the ability to build their own gas-fired generation units. The risk of self-

1 generation is present in today's marketplace because SCE&G is pricing themselves out of
2 the market.

3
4 **Q. IS SCE&G'S ONGOING CONSTRUCTION PROGRAM THE REASON THAT**
5 **THE COMPANY'S RATES ARE HIGHER THAN NEIGHBORING UTILITIES?**

6 A. Not necessarily. In the above two tables, both Duke Energy and Georgia Power are
7 involved in extensive construction cycles. As the Commission is well aware, Duke
8 Energy is in the process of completing the Cliffside Nuclear Plant and two major natural
9 gas-fired generation projects. Similarly, Georgia Power is in the midst of, itself, building
10 a nuclear plant. In both cases, the rates offered by Duke and Georgia Power are lower
11 than rates offered by SCE&G.

12
13 **Q. CAN YOU PROVIDE AN EXAMPLE OF THE RISK OF A COMPANY**
14 **LEAVING ITS UTILITY PROVIDER IN SEARCH OF LOWER ELECTRIC**
15 **COSTS?**

16 A. Yes. Under threat of closing its operations, Alcoa forced Santee Cooper to provide the
17 aluminum manufacturer lower alternative rates. In Appendix B is an article from *The*
18 *Post and Courier* that describes the threat that Alcoa presented to Santee Cooper
19 regarding the loss of the aluminum smelters total load. As the article notes, with the price
20 of natural gas at its current very low levels, it is imperative that heavy users of electricity,
21 which certainly includes aluminum smelters, take whatever steps are necessary to
22 maintain their competitiveness on a global level. The article notes that aluminum
23 smelters have located in countries such as Iceland, Brazil, South Africa, and Saudi
24 Arabia. If Santee Cooper were to lose the Alcoa plant in Mount Holly, the area would
25 lose 600 jobs and electric rates for all other Santee Cooper consumers could increase
26 12%.

27
28 **Q. HOW MUCH HAVE SCE&G INDUSTRIAL COSTS INCREASED OVER THE**
29 **PAST TEN YEARS?**

1 A. Data for industrial costs per utility by year is not available prior to 2004. However, the
2 table below shows the average industrial costs for SCE&G from 2004 through 2011
3 along with the annual increases and the cumulative increases over this eight-year period.
4

5 **Table 3: SCE&G Average Industrial Costs**
6

Year	Avg. Annual Ind. Costs	Annual Cost Inc.	Cumulative Cost Inc.
2004	4.39	N/A	N/A
2005	4.93	12.3%	12.3%
2006	5.08	3.0%	15.7%
2007	5.23	3.0%	19.1%
2008	6.34	21.2%	44.4%
2009	6.48	2.2%	47.6%
2010	6.67	2.9%	51.9%
2011	6.95	4.2%	58.3%

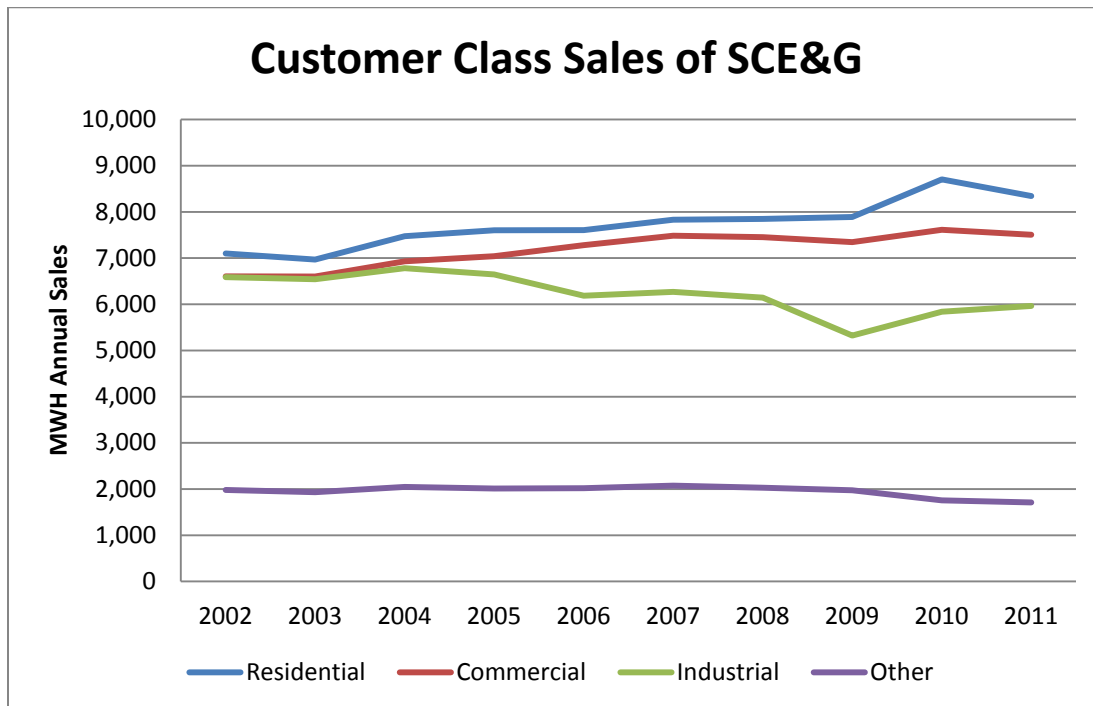
Source for Raw Data: EIA Annual Reports, Table 8

7
8 As can be seen in the above table, industrial costs from SCE&G have soared over 58%
9 since 2004. Consumers, especially manufacturers that compete in a global market,
10 simply cannot sustain such massive cost increases over a relatively short period of only
11 eight years.
12

13 **Q. MR. O'DONNELL, HOW HAVE SCE&G'S SALES CHANGED OVER THE**
14 **PAST TEN YEARS?**

15 A. Over the past ten years, industrial sales of SCE&G have fallen while residential and
16 commercial loads have increased. In Figure 1 below is a comparison of the load growth
17 of the residential, commercial, industrial, and "other" customer classes of SCE&G from
18 2002 through 2011.

Figure 1: SCE&G Historical Sales by Customer Class



As can be seen from the above chart, the need for additional plant is being driven by the residential and commercial classes as the industrial sales for SCE&G have fallen over the past ten years. This loss in industrial load is more than just a loss of sales to large customers. This lost industrial load is also representative of the loss of manufacturing jobs in the SCE&G territory. A continuation of rate increases to manufacturers in SCE&G's territory may exacerbate the upward push on residential and commercial rates as those customers will be required to pick up any revenue loss that stems from the continued decrease in industrial sales.

Q. DO YOU HAVE AN ESTIMATE AS TO HOW MUCH SCE&G'S RATES WILL CHANGE IN THE NEXT TEN YEARS?

A. Yes. Based on public estimates, it appears that SCE&G's rates will increase approximately 20% on a cumulative basis between 2013 and 2010. Given SCE&G's

1 already relatively high rates, another 20% increase will surely make the utility even less
2 competitive in terms of economic development.
3

4 **Q. PLEASE EXPLAIN THE ROLE OF MANUFACTURING IN THE SOUTH**
5 **CAROLINA ECONOMY.**

6 A. Although manufacturing activity has declined in recent years, manufacturing is still one
7 of the primary economic engines for South Carolina. Some facts obtained from the
8 website of the South Carolina Manufacturing Alliance (SCMA) are as follows: the
9 average salary paid in manufacturing is still about \$15,000 more than other jobs in South
10 Carolina; the manufacturing sector employs 15% of all South Carolinians; and
11 manufacturing pays more than 20% of all wages paid in the state. Clearly, this sector of
12 the economy is still a vitally important sector in the state's economy. To promote
13 vibrancy in the manufacturing sector within its service territory, it is imperative that the
14 Company do what it can to immediately control costs not only to manufacturers but to all
15 its customers.
16

1

2 **II. ECONOMIC AND REGULATORY POLICY GUIDELINES**

3 **FOR A FAIR RATE OF RETURN**

4

5 **Q. PLEASE BRIEFLY DESCRIBE THE ECONOMIC AND REGULATORY**

6 **POLICY CONSIDERATIONS YOU HAVE TAKEN INTO ACCOUNT IN**

7 **DEVELOPING YOUR RECOMMENDATION CONCERNING THE FAIR RATE**

8 **OF RETURN THAT SCE&G SHOULD BE ALLOWED THE OPPORTUNITY TO**

9 **EARN.**

10 A. The theory of utility regulation assumes that public utilities are natural monopolies.

11 Historically, it was believed or assumed that it was more efficient for a single firm to

12 provide a particular utility service than multiple firms. Even though deregulation for the

13 procurement of natural gas and generation of electric power and energy is spreading, the

14 delivery of these products to end-use customers will continue to be considered a natural

15 monopoly for the foreseeable future. When it is deemed that a perceived natural

16 monopoly does in fact exist, regulatory authorities regulate the service areas in which

17 regulated utilities provide service, e.g. by assigning exclusive franchised territories to

18 public utilities or by determining territorial boundaries where disputes arise, in order for

19 these utilities to provide services more efficiently and at the lowest possible cost. In

20 exchange for the protection of its monopoly service area, the utility is obligated to

21 provide adequate service at a fair, regulated price.

22

23 This naturally raises the question - what constitutes a fair price? The generally accepted

24 answer is that a prudently managed utility should be allowed to charge prices that allow

25 the utility the opportunity to recover the reasonable and prudent costs of providing utility

26 service and the opportunity to earn a fair rate of return on invested capital. This fair rate

27 of return on capital should allow the utility, under prudent management, to provide

28 adequate service and attract capital to meet future expansion needs in its service area.

29 Obviously, since public utilities are capital-intensive businesses, the cost of capital is a

1 crucial issue for utility companies, their customers, and regulators. If the allowed rate of
2 return is set too high, then consumers are burdened with excessive costs, current investors
3 receive a windfall, and the utility has an incentive to overinvest. If the return is set too
4 low, adequate service is jeopardized because the utility will not be able to raise new
5 capital on reasonable terms.

6
7 Since every equity investor faces a risk-return tradeoff, the issue of risk is an important
8 element in determining the fair rate of return for a utility.

9
10 Regulatory law and policy recognize that utilities compete with other firms in the market
11 for investor capital. In the case of Federal Power Commission v. Hope Natural Gas
12 Company, 320 U.S. 591 (1944), the U.S. Supreme Court recognized that utilities compete
13 with other firms in the market for investor capital. Historically, this case has provided
14 legal and policy guidance concerning the return which public utilities should be allowed
15 to earn:

16
17 In that case, the U.S. Supreme Court specifically stated that:

18 "...the return to the equity owner should be commensurate with returns on investments
19 in other enterprises having corresponding risks. That return, moreover, should be
20 sufficient to assure confidence in the financial integrity of the enterprise so as to
21 maintain credit and attract capital." (320 U.S. at 603)

1 **III. COST OF COMMON EQUITY**
2

3 **Q. PLEASE EXPLAIN HOW THE ISSUE OF DETERMINING AN**
4 **APPROPRIATE RETURN ON A UTILITY'S COMMON EQUITY**
5 **INVESTMENT FITS INTO A REGULATORY AUTHORITY'S**
6 **DETERMINATION OF FAIR, JUST, AND REASONABLE RATES FOR**
7 **THE UTILITY.**

8 A. In South Carolina and in all regulatory jurisdictions, a utility's rates must be fair,
9 just, and reasonable. Regulation recognizes that utilities are entitled to an
10 opportunity to recover the reasonable and prudent costs of providing service, and
11 the opportunity to earn a fair rate of return on the capital invested in the utility's
12 facilities, such as power plants, transmission lines, distribution lines, buildings,
13 vehicles, and similar long-lived capital assets. Utilities obtain capital funding
14 through a combination of borrowing (debt financing) and issuing stock. The
15 allowed return on equity (ROE) is the amount that is determined to be appropriate
16 for the utility's common stockholders to earn on the capital that they contribute to
17 the utility when they buy its stock. If the regulatory authority sets the ROE too
18 low, the stockholders will not have the opportunity to earn a fair return; if the
19 regulatory authority sets the ROE too high, the customers will pay too much, and
20 the resulting rates will be unfair and unreasonable.

21
22 **Q. HOW DO REGULATORY AUTHORITIES GO ABOUT DETERMINING**
23 **WHAT IS A FAIR RATE OF RETURN ON EQUITY?**

24 A. Regulatory commissions and boards, as well as financial industry analysts,
25 institutional investors, and individual investors, use different analytical models
26 and methodologies to estimate/calculate reasonable rates of return on equity.
27 Among the measures used are "Discounted Cash Flow" or "DCF" analysis and
28 "Comparable Earnings Analysis." Sometimes a technique called the "Capital
29 Asset Pricing Model" or "CAPM" method is used but, as I will discuss later in
30 this testimony, I do not believe the CAPM produce realistic results in modern

1 markets. I believe that the two most useful methodologies are DCF Analysis and
2 the Comparable Earnings Analysis.

3
4 **A. Discounted Cash Flow (DCF) Analysis**

5
6 **Q. CAN YOU PLEASE EXPLAIN THE DISCOUNTED CASH FLOW**
7 **METHOD?**

8 A. Yes. The DCF method is a widely used method for estimating an investor's
9 required return on a firm's common equity. In my twenty-six years of experience
10 with the Public Staff of the North Carolina Utilities Commission and as a
11 consultant, I have seen the DCF method used much more often than any other
12 method for estimating the appropriate return on common equity. Consumer
13 advocate witnesses, utility witnesses and other intervenor witnesses have used the
14 DCF method, either by itself or in conjunction with other methods such as the
15 Comparable Earnings Method or the Capital Asset Pricing Model, in their
16 analyses.

17
18 The DCF method is based on the concept that the price which the investor is
19 willing to pay for a stock is the discounted present value or present worth of what
20 the investor expects to receive as a result of purchasing that stock. This return to
21 the investor is in the form of future dividends and price appreciation. However,
22 price appreciation can be ignored since appreciation in price is only realized when
23 the investor sells the stock. Therefore, the only income that the investor will
24 receive from the company in which it invests is the dividend stream.
25 Mathematically, the relationship is:

26
27 Let D = dividends per share in the initial future period
28 g = expected growth rate in dividends
29 k = cost of equity capital
30 P = price of asset (or present value of a future stream of dividends)
31

$$\text{then } P = \frac{D}{(1+k)} + \frac{D(1+g)}{(1+k)^2} + \frac{D(1+g)}{(1+k)^3} + \dots + \frac{D(1+g)}{(1+k)^t}$$

This equation represents the amount (P) an investor will be willing to pay for a share of common equity with a given dividend stream over (t) periods.

Reducing the formula to an infinite geometric series, we have:

$$P = \frac{D}{k-g}$$

Solving for k yields:

$$k = \frac{D}{P} + g$$

Q. MR. O'DONNELL, DO INVESTORS IN UTILITY COMMON STOCKS REALLY USE THE DCF MODEL IN MAKING INVESTMENT DECISIONS?

A. Absolutely. Utility investors tend to be individuals or institutions interested in current income. Given the current historically low environment for fixed income securities, many investors are looking at utility stocks as somewhat “bond equivalents” right now in that utility stocks provide excellent income sources during a time of low interest rates. In today’s investment environment, the average stock investor will calculate the amount of funds he/she will receive relative to the initial investment, which is defined as the current dividend yield and the amount of funds that the investor can expect in the future from the growth in the dividend. The combination of the current dividend yield and the future growth in dividends is central to the basic tenet of the DCF model.

Q. HAVE YOU USED THE DCF MODEL IN ANALYZING COMMON STOCKS FOR INVESTMENT PURPOSES?

1 A. Yes. I have used and continue to use the DCF method extensively in analyzing
2 common stocks for potential personal purchases as well as for purchases
3 contemplated for money management clients that I have served.
4

5 Although the DCF formula stated above may appear complicated, the DCF
6 method is intuitively a very simple model to understand. To determine the total
7 rate of return one expects from investing in a particular equity security, the
8 investor adds the dividend yield which he or she expects to receive in the future to
9 the expected growth in dividends over time. If the regulatory authority sets the
10 rate at a fair level, the utility will be able to attract capital at a reasonable cost,
11 without forcing the utility's customers to pay more than necessary to attract
12 needed capital.
13

14 Unlike models such as the CAPM that are more theoretical and academic in
15 nature, the DCF is grounded in solid practicality that is used by money managers
16 and individual investors throughout the world on a daily basis.
17

18 **Q. CAN YOU GIVE AN EXAMPLE?**

19 A. Yes. If investors expect a current dividend yield of 5%, and also expect that
20 dividends will grow at 4%, then the DCF model indicates that investors would
21 buy the utility's common stock if it provided a return on equity of 9%.
22

23 **Q. HAVE YOU PREPARED ANY ANALYSES USING THE DCF METHOD**
24 **TO EVALUATE A FAIR RATE OF RETURN FOR SCE&G?**

25 A. Yes, I have. First, I identified a group of 18 comparable companies and then
26 proceeded to evaluate their current and projected dividend yields and growth.
27

1 I developed this group of comparable companies to ensure that the return on
2 equity for SCE&G developed in this analysis is consistent with the returns which
3 can be obtained from similar equity investments in the open market.

4
5 I was not able to perform a DCF analysis directly on SCE&G since it is a
6 subsidiary of SCANA Corp. However, since SCANA is publicly traded, I was
7 able to perform a rate of return analysis on the parent company.

8
9 **Q. PLEASE EXPLAIN HOW YOU SELECTED THESE 18 COMPANIES**
10 **FOR YOUR COMPARABLE GROUP**

11 A. All of the companies in my comparable group are listed in The Value Line
12 Investment Survey "Electric Utility Industry" group.

13
14 Further, I screened my comparable group of companies to include only those
15 companies in the comparable group that have an S&P Quality Rating of a B+,
16 which is the quality rating for SCANA, or an A-, the next highest quality rating.
17 This quality rating is an appropriate screening method because the S&P Quality
18 Rating measures stability of earnings and dividends.

19
20 I also chose to exclude companies that either paid no dividend, had recently
21 reinstated their dividends, had recently purchased another company, or were the
22 subject of takeover discussions. Since SCANA's dividend is secure and SCANA
23 is not involved, to my knowledge, in any merger discussions, I omitted companies
24 that met the above criteria.

25
26 **Q. WHAT DIVIDEND YIELD DO YOU THINK IS APPROPRIATE FOR USE**
27 **IN THE DCF MODEL?**

28 A. I have calculated the appropriate dividend yield by averaging the dividend yield
29 expected over the next 12 months for each comparable company, as reported by
30 the Value Line Investment Survey. The period covered is from July 13, 2012,

1 through October 5, 2012. To study the short-term as well as long-term
2 movements in dividend yields, I examined the 13-week, 4-week, and 1-week
3 dividend yields for the comparable group. My results appear in O'Donnell
4 Exhibit No. KWO-1 and show a dividend yield range of 4.2 to 4.3% for the
5 comparable group and 4.1% to 4.2% for SCANA Corp. during the three time
6 periods that I examined
7

8 **Q PLEASE EXPLAIN HOW YOU DEVELOPED THE DIVIDEND YIELD**
9 **RANGES DISCUSSED ABOVE?**

10 A. I developed the dividend yield range for the comparable group by averaging each
11 Company's dividend yield over the above-stated 13-week and 4-week periods as
12 well as examining the most recent dividend yield reported by Value Line for each
13 company.
14

15 **Q. HOW DID YOU DERIVE THE EXPECTED GROWTH RATE?**

16 A. I used several methods in determining the growth in dividends that investors
17 expect. The first method I used was an analysis commonly referred to as the
18 "plowback ratio" method. If a company is earning a rate of return (r) on its
19 common equity, and it retains a percentage of these earnings (b), then each year
20 the earnings per share (EPS) are expected to increase by the product (br) of its
21 earnings per share in the previous year. Therefore, br is a good measure of
22 growth in dividends per share. For example, if a company earns 10% on its
23 equity and retains 50% (the other 50% being paid out in dividends), then the
24 expected growth rate in earnings and dividends is 5% (50% of 10%). To calculate
25 a plowback for the comparable group, I used the following formula:
26

$$27 \quad g = \frac{\text{br (2011)} + \text{br (2012E)} + \text{br (2013E)} + \text{br (2015E-2017E Avg)}}{4}$$

28
29

1 The plowback estimates for all companies in the comparable group can be
2 obtained from The Value Line Investment Survey under the title "percent retained
3 to common equity." Exhibit No. KWO-2 lists the plowback ratios for each
4 company in the comparable group. This exhibit contains one reference to "NMF"
5 which is the abbreviation for "no meaningful figure". When "NMF" appears, a
6 company's earnings were less than the dividend paid out, which means that the
7 Company did not reinvest or "plowback" any earnings from that year's operations.
8 For purposes of being conservative, I treated the "NMF" entries as a 0 for
9 purposes of my analysis. The plowback method is a very useful tool for
10 comparing the comparable group's growth rates on a recent historical basis as
11 well as a short-term forecasted basis.

12
13 A key component in the DCF Method is the expected growth in dividends. In
14 analyzing the proper dividend growth rate to use in the DCF Method, the analyst
15 must consider how dividends are created. Since dividends cannot be paid out
16 without the company first earning the funds paid out, earnings growth is a key
17 element in analyzing the expected growth in dividends. Similarly, what remains in
18 a company after it pays its dividend is reinvested, or "plowed back", into the
19 company in order to generate future growth. As a result, book value growth is
20 another element that, in my opinion, must be considered in analyzing a company's
21 expected dividend growth. To analyze the expected growth in dividends, I believe
22 the analyst should first examine the historical record of past earnings, dividends,
23 and book value. Hence, the second method I used to estimate the expected
24 growth rate was to analyze the historical 10-year and 5-year historical compound
25 annual rates of change for earnings per share (EPS), dividends per share (DPS),
26 and book value per share (BPS) as reported by Value Line.

27
28 Value Line is the most recognized investment publication in the industry and, as
29 such, is used by professional money managers, financial analysts, and individual
30 investors worldwide. A prudent investor examines all aspects of a Company's

1 performance when making a capital investment decision. As such, it is only
2 practical to examine historical growth rates for the company for which the
3 analysis is being performed. The historical growth rates for the comparable group
4 can be seen in O'Donnell Exhibit No. KWO-1. Some analysts, such as Mr.
5 Hevert, will not present historical growth rates in their DCF analyses. I believe
6 analysts that do not present all such available data fail to completely inform the
7 respective regulatory bodies of the full extent of information on which investors
8 base their expectations.

9
10 The third method I used was the Value Line forecasted compound annual rates of
11 change for earnings per share, dividends per share, and book value per share.

12
13 The fourth method I used was the forecasted rate of change for earnings per share
14 that analysts supplied to Charles Schwab & Co. This forecasted rate of change is
15 not a forecast supplied by Charles Schwab & Co. but is, instead, a compilation of
16 forecasts by industry analysts.

17
18 The details of my DCF results can be seen in Exhibit No. KWO-1.

19
20 It is important to understand the reasons why the various data results appear from
21 Exhibit KWO-1. In the early 1990s, most baseload plant construction had ended
22 and utilities were flush with cash thereby creating solid earnings growth. Earnings
23 growth fell off in the early 2000s but has increased in the past five years as
24 utilities, in general, have been building generation and filing more frequent rate
25 cases.

26
27 The explanation above of utility growth patterns over recent history is necessary
28 in order to understand current and past market conditions so the analyst can use
29 his/her best judgment in determining the market expected dividend growth rate in
30 the future.

1

2 **Q. WHAT IS THE INVESTOR RETURN REQUIREMENT FROM THE DCF**
3 **ANALYSIS?**

4 A. As can be seen on Exhibit KWO-1, the dividend yield for the three time-frames
5 studied ranges from 4.2% to 4.3% for the comparable group and 4.1% to 4.2% for
6 SCANA Corp. For purposes of this analysis, I believe the proper dividend yield to
7 use in the DCF analysis is 4.25% for both the comparable group and SCANA
8 Corp.

9

10 In terms of the proper dividend growth rate to employ in this analysis, I believe
11 that it is appropriate to examine the recent history of earnings and dividend
12 growth to assess and provide the best estimate of the dividend growth that
13 investors expect in the future. A quick examination of the 10-year and 5-year
14 historical growth rates for the comparable group show a wide range of historical
15 growth rates, particularly for the past 5-year period. Northeast Utilities, Public
16 Service Enterprise Group, and UNS Energy have clearly experienced stellar
17 growth in earnings over the past five years that helped the comparable growth rate
18 achieve five-year growth in earnings of 6.2%. Unfortunately for these utilities, the
19 forecasted growth rates of earnings for each company is well below what these
20 utilities achieved in the past five-years.

21

22 The fact that the comparable group forecasted growth rates are all between 4.5%
23 and 4.8% tells me that this group, as a whole, is expected to return to the days of
24 slow but steady growth in earnings, dividends, and book value.

25

26 Over the past five-year period, the growth rate of the SCANA Corp. dividends has
27 doubled the growth rate of its earnings. Such disparity in the growth of dividends
28 versus earnings is expected to reverse itself in the coming years due, in large part,
29 to the capital-intensive construction of the Summer Nuclear Plant in Jenkinsville,
30 South Carolina.

1
2 Once the V.C. Summer Nuclear Plant is completed, it is expected that the
3 SCANA earnings will be strong for many years to come as the large nuclear plant
4 rate base investment will provide the Company with a strong stream of earnings
5 similar to what most utilities experienced in the 1980s when utilities were last
6 involved in large generation construction projects.

7
8 Due to the effects of fundamental changes that have occurred in the utility
9 industry over the past ten years, I believe that it is proper to place more weight on
10 forecasted figures than historical figures in estimating the cost of equity for the
11 comparable group. As a result, I believe that the proper growth rate range for the
12 comparable group of companies to use in the DCF analysis is 4.5% to 5.0%. This
13 growth rate range recognizes that most electric utilities will be undergoing plant
14 expansions in the near term and simply cannot be expected to grow their
15 dividends at the same pace of earnings growth. Thus, the 4.5% to 5.0% growth
16 rate range is right in the middle of the range for the comparable group's growth
17 forecasted rates for the Value Line's forecasted earnings, dividends, and book
18 value per share.

19
20 Combining the comparable group's dividend yield range of 4.25% with the
21 growth rate range of 4.5% to 5.0% produces a DCF range of 8.75% to 9.25%.

22
23 For SCANA, I believe the proper growth rate range is also in the range of 4.5% to
24 5.0%. The lower end of the range is appropriate since it is in the middle of the
25 forecasted SCANA earnings growth as reported by Value Line and Schwab. I
26 believe 5.0% is appropriate for the upper end of the range because it is slightly
27 lower than the Value Line forecasted growth in book value, which is largely
28 attributable to the construction of the Summer Nuclear Plant, and equal to the
29 forecasted EPS figures as shown by Schwab. I believe that investors recognize
30 that the Base Load Review Act (BLRA) provides security for the Company and

1 its investors in that rates are allowed to rise incrementally to pay for financing
2 costs of the V.C Summer Nuclear Plant. Hence, it is logical to see that book value
3 growth will rise in the future at a rate higher than expected relative to earnings
4 and dividend growth.

5
6 SCANA is in the midst of a construction cycle. Its payout ratio, which is a
7 measure of the dividend payout relative to earnings needed to pay the dividend, is
8 high thereby indicating that future dividend increases will be less than earnings
9 growth. Since the DCF formula is predicated on future dividend growth, it would
10 be, as stated above, inaccurate to use only earnings growth rates in the DCF.
11 Doing so produces unrealistically high return on equity numbers that cannot be
12 sustained in real life. To mitigate this problem, I have presented EPS, DPS, and
13 BPS figures to the Commission and systematically explained my rationale for
14 arriving at the above stated growth rates. I believe it is incumbent upon every
15 analyst presenting testimony in this case to present such a robust analysis to the
16 Commission.

17
18 Combining SCANA's dividend yield of 4.25% with the growth rate range of 4.5%
19 to 5.0% produces a DCF range of 8.75% to 9.25%.

20
21 The above-stated comparable group cost of equity range represents only one
22 analysis I used in the examination of the proper cost of equity to apply in the
23 current rate case.

24 25 26 **B. Comparable Earnings Analysis**

27
28 **Q. MR. O'DONNELL, WOULD YOU PLEASE EXPLAIN WHY YOU**
29 **PERFORMED A COMPARABLE EARNINGS ANALYSIS IN ADDITION**
30 **TO YOUR DCF ANALYSIS?**

1 A. Yes. The comparable earnings method provides investors with actual historical
2 earned returns on common equity. Investors use this information as a guide to
3 assess an investment's current required rate of return. I used the comparable
4 earnings method in my analysis in this case to assess the reasonableness of my
5 DCF results and to provide an independent methodological estimate of the return
6 that investors would consider reasonable for SCANA.
7

8 **Q. WOULD YOU PLEASE EXPLAIN HOW YOU PERFORMED THE**
9 **COMPARABLE EARNINGS ANALYSIS?**

10 A. Exhibit No. KWO-3 presents a list of the earned returns on equity of the
11 comparable group over the period of 2010 through 2016. I picked this range so as
12 to provide the Commission with two years of historical returns as well as four
13 years of forecasted returns. As can be seen in this exhibit, the comparable
14 companies' earned returns on equity were quite strong, 11.4%, in 2010 and 11.0%
15 in 2011. The forecasted return on equity for the comparable companies is
16 expected to decrease slightly in the future with returns of 9.9% in 2012 and 10.8%
17 for the period of 2014 through 2016.
18

19 Over the past two years, SCANA has performed slightly worse than the average
20 of the comparable companies with returns of 10.2% in 2010 and 10.0% in 2011.
21 In the current year, 2012, SCANA is expected to earn 10.0% again. Over the
22 period of 2014 through 2016, SCANA is expected to earn a return on equity of
23 9.5%.
24

25 **Q. WHAT CONCLUSIONS DO YOU DRAW FROM THE COMPARABLE**
26 **EARNINGS ANALYSIS?**

27 A. Based on the above-stated findings, I believe the proper rate of return using a
28 comparable earnings analysis is in the range of 9.5% to 10.5%. The 9.5% lower
29 end of the range is equal to the earned return on equity of SCANA Corp. for the
30 forecasted period of 2014 through 2016 and the 10.5% return on equity for the

1 high end of the range is close to the forecasted return on equity of the comparable
2 companies over this same period. In addition, this range of 9.5% to 10.5% is very
3 close to the center point of the recent historical earned returns on equity as well as
4 the expected return on equity for SCANA Corp. and the comparable group in
5 2012.

6 7 8 **C. Return on Equity Recommendation**

9
10 **Q. WHAT IS YOUR RECOMMENDATION FOR THE RETURN ON**
11 **EQUITY AND OVERALL RATE OF RETURN THE COMMISSION**
12 **SHOULD USE IN THIS PROCEEDING?**

13 **A.** As I mentioned earlier, the results from my DCF Analysis resulted in an investor
14 return requirement range of 8.75% to 9.25% for the comparable group and for
15 SCANA Corp.

16
17 The comparable earnings method produces a return on equity in the range of 9.5%
18 to 10.5%. My specific recommendation in this case is for the Commission to
19 grant SCANA a return on equity of 9.5%. This 9.5% ROE is slightly higher than
20 the high end of the range of the DCF results for SCANA and the comparable
21 group and is in the low-end of the range for the comparable earnings analysis.

22
23 In making this recommendation, I believe the Commission should recognize the
24 strength in the stock market in 2011 and 2012 and, in particular, the movement
25 into utility stocks as what I refer to as “bond equivalents”. As the Commission is
26 aware, interest rates are at historic lows. Individuals seeking an income stream see
27 utility dividends as good alternatives at the present time with the lack of adequate
28 fixed income (bond) opportunities. As a result, utility stock prices have soared in
29 the past two years. For example, at the beginning of 2011, the Dow Jones Utility

1 Index stood at 404.99. On Oct. 11, 2012, the Dow Jones Utility Index had risen to
2 478.33 thereby representing an increase in utility stock prices of 15.3%. When
3 stock prices increase, dividend yields decrease. Hence, over the past two years,
4 the increase in utility stock prices has driven dividend yields of utility stocks
5 downward. Utility stock investors should be quick-of-foot: however, utility prices
6 will undoubtedly fall when interest rates reverse the recent trend and increase as
7 the United States and world economies slowly crawl out of the current prolonged
8 economic malaise.

9
10 Since, in my view, the current interest rate environment will not last forever and
11 interest rates will eventually rise, I believe the current DCF results should be
12 slightly discounted and, therefore, my 9.5% ROE recommendation in this case is
13 above the DCF range for SCANA and the comparable group.

14
15 Another reason for my recommendation of 9.5% as opposed to the 9.25% high
16 point of my DCF range is that, as will be seen in the following capital structure
17 section of my testimony, I am herein recommending the Commission adopt the
18 June 30, 2012 SCANA capital structure as opposed to the Company's requested
19 SCE&G capital structure. Since the SCANA capital structure has slightly more
20 financial risk than the SCE&G capital structure, I am recommending a slightly
21 higher return on equity to account for the higher financial risk.

1

2 **D. Capital Structure**

3

4 **Q. MR. O'DONNELL, HAVE YOU REVIEWED THE CAPITAL**
5 **STRUCTURE REQUESTED BY THE COMPANY IN THIS**
6 **PROCEEDING?**

7 A. Yes, I have.

8

9 **Q. MR. O'DONNELL, WHAT CAPITAL STRUCTURE IS SCE&G SEEKING**
10 **IN THIS CASE?**

11 A. According to the Company's application, SCE&G is seeking approval of the
12 following capital structure in this case:

13

14 Table 4: SCE&G Requested Capital Structure

Component	Capital Components \$	Capital Structure Ratio (%)
Long-term Debt	\$3,415,425,000	47.82%
Preferred Stock	\$100,000	0.00%
Common Equity	<u>\$3,726,171,908</u>	<u>52.18%</u>
Total Capitalization	\$7,141,696,908	100.00%

15

16

17 **Q. WHAT IS A CAPITAL STRUCTURE AND HOW WILL IT IMPACT THE**
18 **REVENUES THAT SCE&G OR ANY OTHER UTILITY IS SEEKING IN**
19 **A RATE CASE?**

20 A. The term "capital structure" refers to the relative percentage of debt, equity, and
21 other financial components that are used to finance a company's investments.

22

23 For simplicity purposes, there are basically three financing methods. The first
24 method is to finance an investment with common equity, which essentially

1 represents ownership in a company and its investments. Common equity returns,
2 which take the form of dividends to stockholders, are not tax deductible which, on
3 a pre-tax basis alone, makes this form of financing about 40% more expensive
4 than debt financing. The second form of corporate financing is preferred stock,
5 which is normally used to a much smaller degree in capital structures. Dividend
6 payments associated with preferred stock are not tax deductible. Corporate debt is
7 the other major form of financing used in the corporate world. There are two basic
8 types of corporate debt: long-term and short-term. Long-term debt is generally
9 understood to be debt that matures in a period of more than one year. Short-term
10 debt is debt that matures in less than one-year. Both long-term debt and short-
11 term debt represents liabilities on the company's books that must be repaid prior
12 to any common stockholders or preferred stockholders receiving a return on their
13 investment.

14
15 **Q. HOW IS A UTILITY'S TOTAL RETURN CALCULATED?**

16 **A.** A utility's total return is developed by multiplying the component percentages of
17 its capital structure represented by the percentage ratios of the various forms of
18 capital financing relative to the total financing on the company's books by the
19 cost rates associated with each form of capital and then totaling the results over all
20 of the capital components. When these percentage ratios are applied to various
21 cost rates, a total after-tax rate of return is developed. Since the utility must pay
22 dividends associated with common equity and preferred stock with after-tax
23 funds, the post-tax returns are then converted to pre-tax returns by grossing up the
24 common equity and preferred stock returns for taxes. The final pre-tax return is
25 then multiplied by the Company's rate base in order to develop the amount of
26 money that customers must pay to the utility for its return on investment and tax
27 payments associated with that investment.

28
29 **Q. HOW DOES CAPITAL STRUCTURE IMPACT THIS CALCULATION?**

1 A. From the above discussion, it is clear to see that costs to consumers are greater
2 when the utility finances a higher proportion of its rate base investment with
3 common equity and preferred stock versus long-term debt. However, long-term
4 debt, which is first in line for repayment, is more risky to the utility than is
5 common equity due to the fact that debt is a contractual obligation as opposed to
6 common equity where no similar obligations exist.

7
8 **Q. WHY SHOULD THE SOUTH CAROLINA PUBLIC SERVICE**
9 **COMMISSION BE CONCERNED ABOUT HOW SCE&G FINANCES ITS**
10 **RATE BASE INVESTMENT?**

11 A. There are two reasons that the Commission should be concerned about how
12 SCE&G finances its rate base investment. The first reason is that the cost of
13 common equity is higher than the cost of long-term debt, so that a higher equity
14 percentage will translate into higher costs to SCE&G's customers with no
15 corresponding improvement in quality of service. Long-term debt is a financial
16 promise made by the company and is carried as a liability on the company's
17 books. Common stock is ownership in the company. Due to the nature of this
18 investment, common stockholders require higher rates of return to compensate
19 them for the extra risk involved in owning part of the company versus having a
20 promissory note from the company.

21
22 The second reason the Commission should be concerned about SCE&G's capital
23 structure is due to the tax treatment of debt versus common equity. Public
24 corporations, such as SCANA, can write-off interest payments associated with
25 debt financing. Corporations are not, however, allowed to deduct common stock
26 dividend payments for tax purposes. All dividend payments must be made with
27 after-tax funds, which are more expensive than pre-tax funds. Since the regulatory
28 process allows utilities to recover all expenses, including taxes, rates must be set
29 so that the utility pays all its taxes and has enough left over to pay its common
30 stock dividend. If a utility is allowed to use a capital structure for ratemaking

1 purposes that is top-heavy in common stock, customers will be forced to pay the
2 associated income tax burden, resulting in unjust, unreasonable, and unnecessarily
3 high rates while giving no added value to the customer. Setting rates through the
4 use of double leverage violates the fundamental principles of utility regulation
5 that rates must be fair but only high enough to support the utility's provision of
6 safe, adequate, and reliable service at a fair price.

7
8 **Q. DO YOU BELIEVE THAT THE CAPITAL STRUCTURE BEING**
9 **PROPOSED BY SCE&G IN THIS CASE IS APPROPRIATE FOR**
10 **RATEMAKING PURPOSES?**

11 A. No. In my analysis of this case, I have found evidence that SCANA Corp. is
12 using its holding company status to double-leverage the capital structure of
13 SCE&G thereby creating excess profits at the expense of captive ratepayers in
14 South Carolina.

15
16 **Q. PLEASE EXPLAIN THE CONCEPT OF "DOUBLE-LEVERAGE" AND**
17 **HOW SCANA CAN USE IT TO CREATE EXCESS PROFITS.**

18 A. SCE&G is a wholly-owned subsidiary of SCANA. Due to the parent/subsidiary
19 relationship, there are no market forces that influence the shape of the SCE&G
20 capital structure. As a result, SCANA can issue long-term debt on its consolidated
21 balance sheet and then invest the funds into SCANA and call it common equity.
22 Since the return on common equity for regulated utilities must be grossed up for
23 taxes and the cost of equity is already twice the cost of debt, captive ratepayers in
24 South Carolina are being asked to pay higher rates to support a portion of
25 SCE&G's common equity that is, truthfully, comprised of lower cost debt.

26
27 In essence, SCANA is seeking to have this Commission use its regulatory
28 authority to effectively arbitrage what is a debt investment into equity returns. If
29 allowed to continue in this case, the Company will be allowed to charge South
30 Carolina consumers roughly 18% in pre-tax equity costs for debt costs that only

1 cost SCANA less than 4%. I believe the Commission should reject and prohibit
2 such manipulation of the regulatory process in this and all future proceedings.
3

4 **Q. PLEASE ANALYTICALLY SHOW HOW SCANA CAN MANIPULATE**
5 **THE REGULATORY PROCESS BY TURNING A 4% INVESTMENT**
6 **INTO A 18% RETURN?**

7 A. If SCANA were to issue debt today, the Company would pay roughly 4% in
8 interest for a long-term bond. Since SCANA owns SCE&G, the Company could
9 then invest its debt proceeds into its regulated subsidiary as common equity. In
10 this case, SCANA Energy Corporation pays the bondholder 4% interest but it
11 receives 10.95% (SCANA's requested return in this case). In this example,
12 SCANA Energy Corporation can almost triple (4% to 10.95%) the return on its
13 debt investment by essentially re-categorizing debt as equity. This debt-to-equity
14 situation gets even more attractive to the utility when one considers that revenues
15 for the utility must be increased (grossed up) to pay for the tax payments required
16 for the utility to earn the 10.95% rate of return. When these tax payments are
17 included, the pre-tax rate of return on equity investments rises to approximately
18 18.5%. Hence, in this example, SCANA Energy Corporation can turn a 4%
19 investment into close to a 20% return simply by turning the debt at the holding
20 company level into common equity at the regulated subsidiary level.
21

22 **Q. DO YOU HAVE ANY EVIDENCE THAT SCANA CORP. IS DOUBLE-**
23 **LEVERAGING ITS REGULATED ASSET INVESTMENTS THEREBY**
24 **CREATING EXCESS PROFITS AT THE EXPENSE OF CAPTIVE**
25 **RATEPAYERS IN SOUTH CAROLINA?**

26 A. Yes. On the next page is a table that lists the June 30, 2012 balance of common
27 equity of SCANA Corp. as well as that of SCANA's two largest subsidiaries,
28 Public Service of North Carolina (PSNC) and SCE&G.
29

1

2

Table 5: Per Books Common Equity Positions

3

	Common Equity as of 6-30-12
SCE&G Common Equity	\$3,757,443,220
PSNC Common Equity	<u>\$676,575,000</u>
Total Subsidiary Common Equity	\$4,434,018,220
SCANA Common Equity	\$4,010,130,619
Double-Leveraged Equity	\$423,887,601

4

5

As can be seen in the table above, SCE&G and PSNC have \$424 million more equity on their books than SCANA Corp. has on its books. Assuming that the average interest rate for this \$424 million was 6% and the pre-tax cost of common equity is 18.5% as previously stated, SCANA can use the regulatory process to create close to \$58 million in excess profits from its captive customers.

6

7

8

9

10

11

What is equally troubling is that SCANA obviously recognizes the benefits of double-leverage and is apparently increasing efforts to generate excess profits. In the table below is the equity positions of SCE&G, PSNC, and SCANA as of Sept. 30, 2009.

12

13

14

15

Table 6: Per Books Common Equity Positions

Common Equity as of 9-30-09

SCE&G Common Equity	\$3,141,459,000
PSNC Common Equity	<u>\$619,412,000</u>
Total Subsidiary Equity	\$3,760,871,000
SCANA Common Equity	\$3,479,229,000
Double-Leveraged Equity	\$281,642,000

As can be seen from the two tables above, SCANA has increased the amount of double-leverage equity from \$281.6 million in June, 2009 to almost \$424 million as of June 30, 2012. In other words, SCE&G is seeking more funds from consumers to earn increasingly excess profits through a creative use of the regulatory system.

Q. HOW DO CREDIT RATING AGENCIES ADDRESS THE DIFFERENCES BETWEEN CAPITAL STRUCTURES OF THE PARENT HOLDING COMPANY VERSUS THE REGULATED SUBSIDIARIES?

A. Standard & Poors (S&P) is the pre-eminent bond rating agency in the world. Two years ago, S&P made the following statement in regard to the credit ratings of a utility subsidiary and its parent company:

Utility subsidiaries' ratings are linked to the consolidated group's credit quality because of the financial linkage of the parent to the subsidiary and the likelihood that, in times of stress or bankruptcy, the parent will consider the utility subsidiary as a resource to be used. Accordingly, our base-case financial analysis primarily

1 focuses on the performance, cash flow, and balance sheet of the
2 consolidated group.
3

4 Source: Methodology: Differentiating The Issuer Credit Ratings Of A
5 Regulated Utility Subsidiary And Its Parent, **Standard &**
6 **Poors**, March 11, 2010
7

8 Based on this statement from Standard & Poors, it is clear that the credit rating of
9 SCE&G is inextricably linked to the capital structure of SCANA Corp. Hence,
10 since ratepayers are already being subjected to incrementally higher interest costs
11 due to the capital structure of SCANA as opposed to that of SCE&G, it is only
12 appropriate for SCE&G consumers to receive some of the benefit of the lower
13 equity ratio associated with the SCANA equity ratio.
14

15 **Q. ARE YOU AWARE OF OTHER STATE PUBLIC SERVICE**
16 **COMMISSIONS THAT CONSIDER THE POSSIBILITY OF DOUBLE-**
17 **LEVERAGE IN UTILITY SUBSIDIARY/PARENT COMPANY**
18 **RELATIONSHIPS?**

19 A. Yes. In Docket No. RPU-2010-0001, p. 95, the Iowa Utilities Board stated the
20 following:
21

22 In looking at a rate-regulated utility's capital structure, the Board
23 traditionally considers the capital structure of the utility company,
24 which includes debt, or the first layer of leverage, as well as any
25 debt at the parent holding company level that could be used for a
26 capital infusion into the utility, which is the second layer of
27 leverage. Without the double leverage adjustment, a subsidiary
28 utility company could manipulate its debt levels at the parent and
29 subsidiary levels to support a higher overall rate of return, as
30 affected by the capital structure, than any utility company that is
31 not in such a position, i.e., that does not have a parent company.
32

33 The Board has rejected utility efforts to avoid double leverage
34 adjustments in several cases, including Docket Nos. RPU-02-3,
35 RPU-02-8, and ARU-02-1. However, the Board in those cases said
36 it would not apply double leverage mechanically in each case, but

rather would examine the particular facts and circumstances in each case where the adjustment is proposed.

Q. GIVEN YOUR DETERMINATION THAT SCE&G CAPITAL STRUCTURE HAS BEEN DOUBLE-LEVERAGED BY SCANA, WHAT ALTERNATIVES TO SCE&G's PROPOSAL HAVE YOU CONSIDERED?

A. The capital structure that most accurately reflects investor expectations is the SCANA consolidated capital structure. The SCANA capital structure is found in Table 7 below.

Table 7: SCANA Capital Structure as of June 30, 2012

Component	Capital Components \$	Capital Structure Ratio (%)
Long-term Debt	\$4,873,395,000	54.86%
Preferred Stock	\$100,000	0.00%
Common Equity	<u>\$4,010,130,619</u>	<u>45.14%</u>
Total Capitalization	<u>\$8,883,625,619</u>	<u>100.00%</u>

As can be seen in the table above, the equity ratio in the SCANA capital structure is almost 100 b

The advantage of using the consolidated capital structure in this proceeding is that this capital stru

The advantage in the use of the SCANA capital structure is that it provides a direct link between the return on equity using SCANA Corp. as the proxy for SCE&G and the actual capital structure of SCANA. In other words, there is a direct link between the capital structure that investors see for SCANA and the cost of equity derived using the DCF model and the comparable earnings method. The revenue requirement impact of using the SCANA capital structure as opposed to the SCE&G capital structure is \$45 million in this case.

Q. WHAT CAPITAL STRUCTURE DO YOU RECOMMEND FOR RATEMAKING PURPOSES IN THIS CASE?

1 A. I recommend that the Commission, for ratemaking purposes, employ the SCANA
2 Corp. capital structure as of June 30, 2012. My recommended capital structure
3 can be seen in table 8 below.

4

5 Table 8: SCEUC Recommended Capital Structure and Embedded Costs

Component	Capital Components \$	Capital Structure Ratio (%)	Cost Rate (%)	Wgtd. Cost Rate (%)
Long-term Debt	\$4,873,395,000	54.86%	5.98%	3.28%
Preferred Stock	\$100,000	0.00%	0.00%	0.00%
Common Equity	<u>\$4,010,130,619</u>	<u>45.14%</u>	9.50%	<u>4.29%</u>
Total Capitalization	\$8,883,625,619	100.00%		7.57%

6

7 As can be seen in the above table, my recommended overall rate of return on
8 investment is 7.57%.

9

10 **Q. DO YOU ALWAYS RECOMMEND THE USE OF THE PARENT**
11 **COMPANY CAPITAL STRUCTURE FOR RATEMAKING PURPOSES?**

12 A. No. Each utility rate increase application must be judged on its own merits and its
13 own facts. I perform the same capital structure analysis in each rate case
14 application in which I am retained. In some cases the evidence leads me to
15 conclude that the proper capital structure to be used for developing rates is the
16 subsidiary capital structure. In other cases, I find that the parent company capital
17 structure is the proper capital structure for ratemaking purposes.

18

19 As an example, I testified in the 2011 Duke Energy Carolinas rate case heard
20 before this Commission. In that case, I recommended the Duke Energy Carolinas,
21 which is a subsidiary of Duke Energy, capital structure as opposed to the parent
22 company capital structure.

23

24 **Q. WHY DID YOU RECOMMEND THE USE OF THE SUBSIDIARY**
25 **CAPITAL STRUCTURE IN THE 2011 DUKE RATE CASE BUT YET**

1 **YOU ARE RECOMMENDING THE PARENT HOLDING COMPANY**
2 **CAPITAL STRUCTURE FOR RATEMAKING PURPOSES IN THIS**
3 **SCE&G RATE CASE?**

4 A. In the 2011 Duke Energy rate case application, I did not find evidence of double-
5 leverage. In the current 2012 SCE&G application, I did find clear evidence of
6 double-leverage. Since SCANA is double-leveraging the capital structure of
7 SCE&G, I have recommended the use of the parent company capital structure in
8 this case.

9

10 **Q. ARE YOU CONCERNED THAT YOUR RECOMMENDATION IN THIS**
11 **CASE MAY CAUSE A CREDIT DOWNGRADE FOR SCE&G?**

12 A. There is always a risk of a credit downgrade for any publicly traded company. In
13 fact, SCE&G was downgraded by Moodys in September, 2011. SCE&G did not
14 have a rate case ongoing last year meaning that an impending rate case decision
15 could not, at that time, have been a concern for Moodys. However, one of the
16 reasons cited by Moodys in the Sept., 2011 credit downgrade was that SCE&G's
17 rates are high in relation to peer utilities and are expected to increase further as
18 construction of the Summer plant continues. If anything, my recommendation in
19 this case may help keep SCE&G's rates down so that, perhaps, a further
20 downgrade will not be warranted in the future.

21

1
2 **E. Review of Company Witness Hevert's Testimony**
3

4 **Q. WHAT METHODS DID MR. HEVERT USE IN HIS ANALYSIS OF THE**
5 **COST OF EQUITY IN THIS PROCEEDING?**

6 A. Mr. Hevert used the DCF model, the Capital Asset Pricing Model (CAPM), which
7 is essentially a risk premium model, and a Bond Yield Plus Risk Premium
8 Approach in his analysis.
9

10 **Q. WHAT ARE THE PRIMARY DIFFERENCES BETWEEN YOUR**
11 **APPLICATION OF THE DCF MODEL AND MR. HEVERT'S**
12 **APPLICATION OF THE DCF?**

13 A. One difference between Mr. Hevert and me is that Mr. Hevert uses forecasted
14 earnings growth estimates as the primary source of dividend growth in the DCF
15 model whereas I use a more global approach that examines historical and
16 forecasted growth in earnings, dividends, and book value. In my opinion, it is in
17 the best interest of the Commission to have all relevant data presented to it and
18 then for the analyst making the recommendation to fully explain why he/she
19 presented the data. Mr. Hevert chooses not to present such data to the
20 Commission. Investors use dividend, earnings, and book value information in
21 determining the price at which they are willing to pay for the stock and, hence, the
22 underlying investor return requirement using the DCF model. I believe the
23 Commission should be presented this same information to it can make an
24 informed decision.
25

26 **Q. MR. O'DONNELL, WHY DO YOU BELIEVE MR. HEVERT PRESENTS**
27 **ONLY EARNINGS GROWTH VALUES IN HIS DCF ANALYSIS?**

28 A. Historically, earnings growth rates are higher than dividend and book value
29 growth rates. By focusing only on forecasted earnings growth, Mr. Hevert has
30 skewed his results upward.

1

2 **Q. MR. O'DONNELL, WHY DO YOU NOT USE THE CAPM IN**
3 **DETERMINING RETURNS ON EQUITY IN UTILITY REGULATORY**
4 **PROCEEDINGS?**

5 A. I have two primary concerns regarding the CAPM's application in setting
6 expected returns on equity. The first concern deals with the assumption in the
7 CAPM that assumes that calculated risk premiums stay relatively constant over
8 time. I have found such assumptions to be unrealistic. The second concern is that
9 the beta in the CAPM is incapable of capturing sudden changes in risk.

10

11 **Q. PLEASE EXPLAIN YOUR CONCERN REGARDING THE RISK**
12 **PREMIUM EMPLOYED IN THE CAPM.**

13 A. Current economic conditions are vastly different from conditions that existed in
14 the marketplace since 1926. For example, from the end of WWII until the mid-
15 1990s, the United States economy was generally seen as the dominant market in
16 the world. Today, however, China and India are all making strong economic
17 strides that are threatening our dominance in world markets.

18

19 In 2004, Dr. Jeremy J. Siegel from the University of Pennsylvania published a
20 paper for the Chartered Financial Analysts Institute Conference Proceedings
21 entitled "The Long-Run Equity Risk Premium." In this study, Dr. Siegel
22 examined stock and bond market return returns from 1802 through 2003. Over
23 this extended period of time, the real return on common stocks was 6.8% whereas
24 the real return on long-term government bonds was 3.5% thereby producing a
25 risk-premium of 3.3%. The summary of the article states:

26

27 This is a lower return world because the P/E for equities is
28 justifiably higher than it has been historically, which implies lower
29 long-term real equity returns. Siegel's constant of a 6.5-7 percent
30 return equity returns problem will not hold for all future periods.
31 Investors probably will receive closer to 5 percent. Nevertheless,
32 the real equity risk premium will still be roughly 3 percent.

1 Investors will certainly seek other higher yielding real assets, but
2 of the three major asset classes – stocks, bonds, and real estate – all
3 are probably going to realize lower return than their historical
4 averages. Consequently, equities still offer an attractive premium
5 for long-term investors.
6

7 Also in 2004, Mr. Robert D. Arnott, editor of the Financial Analysts Journal,
8 wrote an article entitled “The Meaning of a Slender Risk Premium.” Mr. Arnott
9 concluded his piece by stating that
10

11 The risk premium rules of thumb we’ve relied on are shaky.
12 Indeed, the risk premium is a skinny hook to hang our future
13 prosperity on. Should we rely on the risk premium for profit, or
14 should we look more aggressively for other paths to profit? I think
15 the latter is by far the more sensible route.
16
17

18 **Q. PLEASE EXPLAIN YOUR STATEMENT THAT THE BETA USED IN**
19 **THE CAPM DOES NOT ADEQUATELY CAPTURE CHANGES IN RISK.**

20 **A.** The CAPM uses a beta variable to measure the risk of the company studied
21 relative to the market. In my view, this beta is highly subjective and can only be
22 used with the utmost care. Since the beta is calculated with historical returns
23 relative to market returns, it is very possible, and in fact quite likely, that sudden
24 changes in a company’s stock price will not be captured in the beta thereby
25 producing meaningless answers. If, for example, the beta used in the analysis was
26 calculated over an extended time period, such as how Value Line calculates its
27 beta, and then a company suddenly encountered severe financial problems, the
28 CAPM would produce meaningless results as the calculated return on equity
29 would be grossly low.
30

31 An example of the problem with beta can be seen in the situation involving
32 Countrywide Financial, which was the world’s largest independent residential
33 mortgage lender and service company. Countrywide has symbolically become the

1 poster child for the credit meltdown that has now occurred in the marketplace
2 thereby setting off recession worries for the entire country. The August 24, 2007
3 edition of Value Line states that Countrywide's stock price had fallen 54% since
4 its May, 2007 report. However, even with this price decline, the calculated beta
5 for Countrywide was just 1.15 as of Aug. 24, 2007 meaning that Countrywide was
6 perceived as being only 15% more risky than the overall stock market. Given the
7 precipitous drop of Countrywide and past concerns of a wide credit meltdown
8 resulting in thousands of homeowners losing their houses at that point in time, it
9 is hard to believe that Countrywide's beta was just 1.15. Applying this beta in a
10 CAPM will provide an absurd result.

11
12 I urge the Commission to consider how each of them, individually, looks at
13 investments and apply the same reasoning to discerning the validity of the DCF
14 and CAPM models. When a person is contemplating making an investment, that
15 person will consider both the short-term and long-term returns in making that
16 investment. With the DCF, the short-term return is represented by the current
17 dividend yield and the long-term growth return is represented in the growth of
18 expected dividends. As a result, the DCF is a practical "real-life" model that is
19 used by investors throughout the world each and every day. The CAPM, on the
20 other hand, is a pure academic model that depends on an assumed risk premium
21 and risk-free rate to arrive at a return on equity estimation. Investors simply do
22 not use such an academic model in the daily "real life" decisions.

23
24 **Q. HAS MR. HEVERT PRESENTED THE CAPM TO THIS COMMISSION**
25 **IN THE PAST?**

26 **A.** Yes. Mr. Hevert presented the CAPM in SCE&G's 2010 rate case.
27

28 **Q. HOW DO MR. HEVERT'S RESULTS IN THE CURRENT CASE**
29 **COMPARE TO HIS RESULTS FROM THE 2012 SCE&G RATE CASE?**

1 A. In 2010 Mr. Hevert presented testimony in which his CAPM results ranged from
2 mean returns of 10.52% to 10.99% (Docket No. 2009-489-E, p. 45, l. 2-8).
3 However, over the past two years, the risk-free rate used in Mr. Hevert's own
4 CAPM analyses (between 2010 and 2012), dropped between 40 and 190 basis
5 points. When I replicated Mr. Hevert's 2010 analysis and only changed the risk-
6 free rate, the CAPM mean ROE results fall to a range of 9.36% to 9.83%. The
7 result of Mr. Hevert's 2010 analysis as compared to my 2012 analysis using Mr.
8 Hevert's 2010 analysis updated with the lower risk-free rate can be seen in Table
9 9 below.

11 Table 9: Comparison of Hevert 2010 CAPM
12 to 2012 Updated CAPM Analysis
13

	Near Term Projected 30- Year Treasury			Long-Term Projected 30- Year Treasury		
	Current Calculated Beta					
	2010 Results	2012 Results	Difference	2010 Results	2012 Results	Difference
Sharpe Ratio Derived Market Risk Premium	10.90%	9.00%	1.90%	11.75%	11.30%	0.45%
Ex-Ante Approach Derived Market Risk Premium	10.23%	8.32%	1.91%	11.08%	10.68%	0.40%
	Average Historical Beta					
Sharpe Ratio Derived Market Risk Premium	10.40%	8.51%	1.89%	11.25%	10.80%	0.45%
Ex-Ante Approach Derived Market Risk Premium	9.79%	7.89%	1.90%	10.64%	10.24%	0.40%

14
15 In the current 2012 proceeding, Mr. Hevert presents testimony where his CAPM
16 produces mean results in the range of 10.43% to 10.79% (Docket No. 2012-218-
17 E, Hevert, p. 31, l. 14-18), which is virtually identical to the mean results of

1 10.52% to 10.99% that Mr. Hevert presented in his 2010 testimony. This above
2 table shows that, even though the risk-free rate has fallen dramatically, Mr.
3 Hevert's CAPM results have barely budged. The fact that Mr. Hevert can come
4 to roughly the same CAPM results from 2010 to 2012 is a clear sign that Mr.
5 Hevert's application of the CAPM is erroneous or the model, itself, has
6 fundamental flaws.

7
8 **Q. MR. O'DONNELL, WHAT RETURN ON EQUITY DID MR. HEVERT**
9 **RECOMMEND IN THE 2010 SCE&G RATE CASE?**

10 A. In the 2010 SCE&G rate case, Mr. Hevert recommended a return on equity of
11 11.60%.

12
13 **Q. HOW DOES MR. HEVERT'S 11.60% ROE RECOMMENDATION IN**
14 **THE 2010 CASE COMPARE TO HIS RECOMMENDATION IN THE**
15 **CURRENT PROCEEDING?**

16 A. Mr. Hevert's recommendation in this case of 11.25% is not significantly different
17 from his recommendation (11.60%) in the 2010 case. However, in the current
18 case, Mr. Hevert uses two different models that are dependent on interest rates.
19 From the 2010 case to the current 2012 case, interest rates have fallen close to 200
20 basis points but, yet, his recommendation has fallen only 35 basis points. Hence,
21 while the capital markets have changed substantially over the past two years and
22 Mr. Hevert, himself, uses two financial models that depend on interest rates, Mr.
23 Hevert ignores the change in the capital markets when making his ROE
24 recommendation in this case.

1

2

IV. ACCOUNTING ADJUSTMENTS

3

4

Q. HAVE YOU REVIEWED THE ACCOUNTING ADJUSTMENTS REQUESTED BY THE COMPANY IN THIS PROCEEDING?

5

6

A. Yes. However, I have not completed a full audit of the Company's application in this as has the ORS. My accounting review was rather narrow. I am aware that the ORS has made a thorough audit of the SCE&G application and will offer substantial reductions.

7

8

9

10

11

Q. DO YOU ACCEPT ALL THE ACCOUNTING CHANGES PROPOSED BY THE COMPANY IN THIS CASE?

12

13

A. No. Several of the accounting changes are unnecessary and other changes are simply excessive in light of the poor South Carolina economy and the Company's ever-increasing uncompetitive electric rates. The accounting adjustments which I recommend the Commission disallow are as follows:

14

15

16

17

18

- 50% of the net revenue loss associated with the terminated wholesale power contract;

19

20

- all employee incentive pay;

21

- EEI dues;

22

- Storm insurance premiums and storm reserves; and

23

- Pension deferral placed into rate base.

24

25

If accepted by the Commission, the result of all my accounting adjustments would reduce O&M expenses sought in this case by approximately \$25 million.

26

27

28

Q. PLEASE EXPLAIN THE REQUEST BY SCE&G IN THIS CASE TO RECOVER AN ADDITIONAL \$30 MILLION IN LOST REVENUE

29

1 **ASSOCIATED WITH THE TERMINATION OF AN EXISTING**
2 **WHOLESALE CONTRACT.**

3 A. In 2003, SCE&G entered into a long-term wholesale power contract to sell 250-
4 MW of the output of the Jasper Generating Station. This wholesale contract ends
5 at the end of 2012 and, in this case, SCE&G is seeking recovery of approximately
6 \$30 million in lost revenues associated with the termination of this agreement.

7
8 **Q. WHY DO YOU OPPOSE THE COMPANY'S RECOVERY OF THE**
9 **ENTIRE AMOUNT OF THE LOST REVENUES ASSOCIATED WITH**
10 **THIS WHOLESALE CONTRACT IN THIS CASE?**

11 A. In response to a SCEUC interrogatory, a copy of which can be found in Exhibit
12 No. KWO-4, SCE&G stated that it attempted to market this excess 250-MW of
13 gas-fired generation to market participants in the Southeast. However, SCE&G's
14 attempts to market this power was limited to only large market participants in the
15 Southeast. There are numerous other smaller wholesale entities which SCE&G
16 never contacted at all for marketing of this excess power. In the past 5 years, I
17 have worked with eleven small municipalities in the Southeast in regard to
18 wholesale power market purchases. During these projects, I have not seen
19 SCE&G attempt to market power. In fact, I have not seen SCE&G attempt to
20 market any power to small market participants in over 10 years. Hence, I can
21 only conclude that SCE&G's attempt to market this extra 250-MW of gas-fired
22 generation was insufficient to market the power to all entities in the Southeast.
23 Given that the Company is in the midst of constructing a very expensive nuclear
24 plant, it would seem logical that the Company would re-double its marketing
25 efforts to place any excess power on its system so as to minimize potential rate
26 increases.

27
28 After discussions with market participants, SCE&G chose to retire its coal-fired
29 Canadys 1 Unit which, according to the testimony of Mr. Byrnes, had a capacity

1 of 90-MW. Hence, the total amount of excess capacity now being placed on the
2 SCE&G system is 160-MW (250 MW less the Canadys 1 output of 90 MW).

3
4 The Company's request in this case is for ratepayers to shoulder the entire burden
5 of paying for this extra 250-MW of generation while the Company attempts to
6 market what it can of the excess power. My recommendation is that the Company
7 and its customers split the risk associated with this excess capacity. A rate
8 requiring consumers to pay the entire amount of lost revenues from this wholesale
9 contract is not just and reasonable. Given that the net amount of extra generation
10 is 160-MW, I recommend the Company and its ratepayers split the cost of the \$30
11 million in lost revenues on a prorata basis. The \$30 million requested for
12 recovery in this case, I recommend the Commission disallow \$9.6 million of that
13 request since the Company should be charged with marketing half of the 160-MW
14 of net generating capacity. If SCE&G can market the full extent of the output of
15 the plant, or even a bit more, it should be able to keep the entire amount of the
16 extra \$9.6 million as a below-the-line credit to profits. However, if SCE&G is not
17 successful in its marketing efforts for the other half of the lost revenues, the
18 Company, not the ratepayers, should pay that difference. In essence, my
19 recommendation shares the risk of the excess generation marketing with the
20 Company and provides SCE&G with an incentive to heavily market this power on
21 a daily basis.

22
23 **Q. HOW DO YOU PROPOSE TO TREAT THE ACCOUNTING OF FUEL**
24 **AND OTHER VARIABLE COSTS ASSOCIATED WITH THE SALE OF**
25 **THIS EXCESS POWER?**

26 A. I believe the Company should pay the costs of all fuel and variable costs
27 associated with the sale of excess power as described above. Hence, under my
28 recommendation, the Company could evaluate the economics of each sale on a
29 net basis to determine whether or not to make the sale.

1 **Q. WHY DO YOU OPPOSE INCENTIVE PAY FOR SCE&G EMPLOYEES?**

2 A. The seasonally adjusted unemployment rate in South Carolina is currently 9.6%.
3 As noted previously in this testimony SCE&G already has some of the highest
4 rates of investor-owned utilities in the Southeast. The time simply is not equitable
5 for SCE&G to ask ratepayers struggling with ever-increasing rates and a difficult
6 economy to pay higher rates to provide utility employees incentives to do their
7 jobs. I realize that this Commission has, in the past, allowed for 50% of employee
8 incentives to be borne by ratepayers, but the current economic situation is unlike
9 past economic events. Ratepayers simply cannot afford a \$6 million luxury payout
10 to SCE&G employees. I recommend the Company's request in this matter be
11 disallowed.

12

13 **Q. PLEASE EXPLAIN SCE&G'S REQUEST TO RATEPAYERS TO**
14 **COMPENSATE THE UTILITY FOR DUES ASSOCIATED WITH THE**
15 **EDISON ELECTRIC INSTITUTE (EEI).**

16 A. EEI is a trade association for investor-owned utilities throughout the United
17 States. According to its website, EEI

18

19 works closely with all of its members, representing their interests and advocating
20 equitable policies in legislative and regulatory arenas.

21

22 EEI provides public policy leadership, critical industry data, strategic business
23 intelligence, one-of-a-kind conferences and forums, and top-notch products and services.

24

25 Mr. Swan presents testimony in this case in which he requests \$200,000 for
26 SCE&G to re-affiliate its membership with EEI. Unfortunately, Mr. Swan does
27 not provide any cost-benefit analysis for why re-affiliation with EEI is in the best
28 interest of ratepayers who are being asked to pay the dues for the association.
29 Since the burden of proof in this rate proceeding lies with the Company and it has
30 not provided any evidence to support its request for ratepayers to pay the
31 Company's EEI dues, I recommend the Commission disallow this expense
32 request.

1

2 **Q. PLEASE EXPLAIN THE CURRENT RETIREMENT PLANS OFFERED**
3 **BY SCE&G TO ITS EMPLOYEES.**

4 A. At the present time, SCE&G offers its employees a noncontributory defined
5 benefit retirement plan (p. 77 of 2012 10-K Annual Report) that covers
6 “substantially all regular, full-time employees”. At a time when corporate
7 America has moved away from defined benefit plans to defined contribution
8 plans, SCE&G’s defined benefit plan is, in my opinion, a relic of the past.

9

10 **Q. WHAT IS THE CURRENT STATUS OF SCE&G’S DEFINED BENEFIT**
11 **PENSION PLAN?**

12 A. According to the Company’s 10-K annual report. SCANA’s pension plan is
13 currently fully funded. To be specific, SCANA states the following on p. 80 of its
14 2011 10-K report:

15

16 The pension trust is adequately funded under current regulations.
17 No contributions have been required since 1997, and the Company
18 does not anticipate making significant contributions to the pension
19 plan until after 2012.

20

21 **Q. HOW DO YOU RECOMMEND THE COMMISSION TREAT THE**
22 **REQUEST OF SCE&G TO PLACE \$33 MILLION IN ITS PENSION**
23 **DEFERRAL IN RATE BASE?**

24 A. Since the pension fund is currently fully funded, I recommend the Commission
25 disallow the Company’s request to place \$33 million in pension deferral into rate
26 base. In addition, I further recommend the Commission not fund any future
27 payments into the SCE&G retirement accounts until the Company ceases its
28 defined benefit at current levels and migrates all employees to defined
29 contribution plans so as to minimize risk to the ratepayers of South Carolina.

30

1 **Q. PLEASE EXPLAIN THE COMPANY’S STORM RECOVERY FUNDING**
2 **REQUEST IN THIS CASE.**

3 A. SCE&G is actually making two requests in this case as it related to Storm
4 Recovery Fund. The first request by SCE&G is that it be allowed to recover
5 approximately \$6.1 million in annual storm recovery expenses that were
6 suspended indefinitely in the Company’s last rate case in 2010. The second
7 request is for the Company to recover \$3.1 million in storm damage insurance
8 premiums to be recovered as normal O&M expenses as opposed to past treatment
9 in which these insurance premiums were recovered through the Storm Recovery
10 Fund.

11
12 The Storm Recovery Fund currently stands at \$30.1 million. If a severe storm
13 occurs in the SCE&G territory and exhausts the entire \$30.1 million storm reserve
14 fund, SCE&G has the option of filing for emergency rate relief and requesting a
15 temporary storm recovery rider. My recommendation is that the Commission
16 deny the request for \$6.1 million in storm recovery expenses as well as \$3.1
17 million in storm damage insurance and leave open the option of the Company
18 filing for relief if/when a severe storm hits the SCE&G service territory.

19
20 **Q. BASED ON YOUR RECOMMENDED COST OF CAPITAL AND THE**
21 **ABOVE-STATED ACCOUNTING ADJUSTMENTS, WHAT IS YOUR**
22 **RECOMMENDED OVERALL REVENUE REQUIREMENT FOR SCE&G**
23 **IN THIS CASE?**

24 A. My proforma accounting adjustments and recommended rate of return can be
25 found in Exhibit KWO-5. If the Commission accepts my recommended cost of
26 capital and my recommended accounting adjustments, the Company’s overall
27 revenue requirement increase would be \$38.25 million as opposed to the \$151.5
28 million requested by SCE&G.

29

1 **V. COST OF SERVICE STUDY AND RATE DESIGN**

2
3 **Q. MR. O'DONNELL, WHAT IS A COST OF SERVICE STUDY AND WHY**
4 **ARE THE RESULTS OF SUCH A STUDY RELEVANT IN THIS**
5 **PROCEEDING?**

6 **A.** A cost of service study is the starting point for any rate design analysis. Before
7 any changes are made to customer class rates, the current cost of serving each
8 customer class and the return which the Company earns on service to that class
9 must be determined. Once these costs have been determined, customer class rates
10 can be increased or decreased in order to bring the resulting class rates of return in
11 line with the costs incurred in serving each class.

12
13 **Q. HOW IS A COST-OF-SERVICE STUDY PERFORMED?**

14 **A.** The first step in performing a cost of service study is to determine the appropriate
15 test year for which all revenues, expenses, and utility plant investment are based.
16 In the case of SCE&G, the most recent test year was for the 12 months ending
17 December 31, 2011.

18
19 The next step in performing a cost-of-service study is to ascertain the proper level
20 of revenues and expenses to use in this analysis. It is the responsibility of the
21 analyst to ascertain that the revenues and expenses used in the analysis are
22 representative of what the utility can expect on an ongoing basis. Since revenues
23 typically do not vary by a great deal from year-to-year, little adjustments are made
24 in this area. Expenses, on the other hand, can vary considerably so careful
25 consideration must be made with each expense.

26
27 Once the revenues and expenses have been adjusted so that they are representative
28 of what the utility reasonably achieved in the test year, the analyst then allocates
29 these revenues and expenses to each of the customer classes. Allocating revenues
30 is a relatively straightforward task since all major utilities, such as SCE&G,

1 normally retain detailed utility revenue accounts for each customer class.
2 Allocating expenses is, however, more difficult because all the expenses are
3 commonly incurred expenses for all customers of the electric distribution system.
4 To allocate these expenses, the analyst must use the allocation factors that are
5 based on factors such as annual usage, demand usage, number of customers, etc.
6 Allocating expenses in this manner is normally called “functionalization” of
7 expenses as the process involves arranging the expenses according to major
8 electric utility functions, such as generation, transmission, and distribution.

9
10 The allocation of operating expense items requires careful consideration as to how
11 these expenses and investments are incurred and utilized and how best to spread
12 these costs. It is very important that the analyst allocate the given expense by the
13 way such cost is incurred or in the manner in which these expense items are
14 utilized. For purposes of simplicity and example, consider the situation with
15 postage expenses. The vast majority of postage expenses are incurred in sending
16 monthly bills to consumers. Since each consumer gets a bill in the mail, it makes
17 sense to allocate postage expenses by the number of customers in each rate class.
18 Thus for postage expenses, residential customers would bear the largest portion of
19 this expense since that class has the largest number of individual customers.

20
21 Operating expenses can be classified into five major groups: production,
22 transmission, distribution, sales, and administrative and general (A&G) expenses.
23 The method of allocation for each of these five groups will vary as to the way in
24 which these expenses are incurred by the electric utility.

25
26 Once the revenues and expenses have been determined by customer class, an
27 income statement is essentially created for each customer class. From this income
28 statement, income taxes can be calculated and then the net income for each
29 customer class is determined.

1 The next step in the cost-of-service study is to allocate the utility's net plant
2 investment, which is defined as gross plant less depreciation, in a cost-causation
3 manner similar to how the analyst allocated expenses. As was the case with
4 expenses, net plant investment, otherwise known as the rate base, is allocated in
5 the manner in which the utility incurs the cost. There are three major types of
6 utility plant investment that require allocation: generation, transmission, and
7 distribution. Of these types of investment, generation investment is generally the
8 largest investment. As the largest investment, allocation of generation is critically
9 important in the calculation of the cost of service to each customer class.

10
11 The last step in the cost-of-service study is to divide the net income for each
12 customer class by the rate base for each class to derive the rate of return earned on
13 service for each customer class. The resulting percentage (%) rate of return for
14 each customer class provides the analyst with a gauge of the profitability of
15 service to each customer class.

16
17 **Q. SHOULD AN ANALYST LOOK AT FACTORS OTHER THAN**
18 **CUSTOMER CLASS RATES OF RETURN WHEN EXAMINING HOW**
19 **TO ADJUST RATES?**

20 **A.** Yes. The analyst should also consider how the particular rate increase may impact
21 the service territory of the utility and the long-term impact of the rate change. For
22 example, a rate increase to a manufacturing customer on the verge of financial
23 collapse may well be the last straw that pushes the employer out of the state or,
24 worse, totally out of business. When that manufacturer closes its door, the load of
25 that customer is probably gone forever meaning that rates for all other customers
26 must concurrently increase to keep the utility whole.

27
28 **Q. PLEASE EXPLAIN WHY RATES FOR OTHER CLASSES MUST GO UP**
29 **WHEN AN INDUSTRIAL CUSTOMER CLOSES ITS DOORS.**

1 A. According to the testimony of SCE&G Witness Swan, SCE&G needs total
2 revenues of \$2.39 billion (Swan Exhibit C-2, p. 2 of 4) to earn its requested rate
3 of return of 8.56%. If an industrial customer closes its facility in South Carolina,
4 remaining customers will need to pick up the revenue difference, less incremental
5 fuel costs, required to serve that industrial customer. If, at the extreme, SCE&G
6 lost all industrial consumers on its system, all remaining ratepayers would realize
7 a rate increase of approximately 25% relative to rates currently allowed. Hence, as
8 stated above, it is critically important that SCE&G do all its power to mitigate
9 future rate increases so as not to burden all remaining customer classes that
10 cannot leave the SCE&G system. This is especially important since SCE&G is
11 building very expensive nuclear power plants which add to the increases
12 consumers are being asked to pay.

13

14 **Q. WHAT IS A “COINCIDENT PEAK” COST-OF-SERVICE STUDY?**

15 A. As stated above, the most critical part of a cost-of-service study for an electric
16 utility is the method in which generation investment is allocated. This one
17 allocation, more so than any other, will have the greatest influence on the
18 resulting customer class rates of return. Since SCE&G is a summer peaking
19 utility, Mr. Hendricks appropriately allocated the Company’s generation
20 investment to all customer classes by a ratio of each class’s peak demand relative
21 to the total peak demand of the entire Hendricks peak demand.

22

23 **Q. DO YOU AGREE WITH ALLOCATING GENERATION INVESTMENT**
24 **BY THE COINCIDENT PEAK?**

25 A. Yes, since SCE&G builds generating plant to meet the peak demand on its
26 system, it make sense to allocate generation investment by the coincident peak
27 ratio.

28

1 **Q. DOES THE COINCIDENT PEAK METHOD REFLECT THE MANNER**
2 **IN WHICH SCE&G’S CUSTOMERS USE ELECTRICITY?**

3 A. Yes. SCE&G has three major customer classes: residential, commercial, and
4 industrial. Of these three classes, the residential class is the most temperature-
5 sensitive and time-sensitive class. Put simply, when the temperature rises outside
6 the home, residential consumers respond by running their air conditioners more
7 frequently. The time at which residential consumers use the most electricity is,
8 typically, the late afternoon hours of a hot summer day when workers come home
9 from work. To accommodate the need for electricity, SCE&G must ramp up its
10 more expensive generating plants to meet this summer peak demand.

11
12 Industrial consumers, on the other hand, keep their energy consumption relatively
13 level as these customers are much less sensitive to temperature fluctuations than
14 are residential consumers. Furthermore, it is often very costly for a large
15 manufacturer to ramp up and down its manufacturing operations due to the
16 stresses that such variations place on manufacturing equipment.

17
18 In the current case, the rates proposed by SCE&G are based upon the coincident
19 peak (CP) cost allocation methodology that does reflect the fact that the
20 generation plant constructed by the Company is built to meet the Company’s peak
21 demand. For the reasons set forth above, SCE&G’s use of the coincident peak
22 allocation methodology is very appropriate for use in the Company’s cost of
23 service study in this proceeding.

24
25 **Q. DO YOU HAVE A RATE DESIGN RECOMMENDATION TO THIS**
26 **COMMISSION?**

27 A. Yes. I recommend that the Commission reduce rates to all consumers to my
28 recommended revenue requirement such that SCE&G receive a \$38.25 million
29 increase in this case. I recommend that the rate increase be spread across all

customer classes in the same proportionate increases initially proposed by the Company. My specific rate increase recommendation as compared to the Company's request can be seen in the below.

Table 9: SCEUC Proposed Rate Changes

Customer Class	Present Revenues	Proposed Base Rate Increase	% Increase
Residential	\$1,017,491,000	\$18,761,693	1.8%
Small Gen. Svc.	\$398,162,000	\$4,292,023	1.1%
Medium Gen. Svc.	\$232,981,000	\$3,635,596	1.6%
Large Gen. Svc.	\$531,288,000	\$10,505,356	2.0%
Lighting	\$55,922,000	\$1,055,333	1.9%
Total	\$2,235,844,000	\$38,250,000	1.7%

Q. DO YOU HAVE ANY FURTHER RATE DESIGN RECOMMENDATIONS FOR THE COMMISSION TO CONSIDER?

A. Yes. I further recommend that SCE&G open its interruptible load to more customers and more load. At the present time, the Company's interruptible program is fully subscribed at 150 MW. To help mitigate SCE&G's already high electric rates on large industrial consumers and minimize the possibility of future plant changes and resulting job losses, I recommend SCE&G open this tariff up to 250 MW of interruptible power. I am aware of two SCEUC members that are interested in expanding their use of the interruptible tariff. Therefore, SCE&G should be required to expand its interruptible program to 250 MW to SCEUC members as well as all industrial customers. I am confident that the Company

1 will find a positive reception amongst its industrial consumers in regard to the
2 interruptible tariff.

3 .

4 In addition to the expansion of the interruptible tariff, I further recommend that
5 SCE&G expand its RTP rates so as to attract more industrial load. As noted
6 above, my recommendation is that the Company take on the responsibility of
7 marketing and selling half of the net 160-MW of the Jasper load that is available
8 at the end of 2012 from the expiration of a wholesale contract. To help market
9 that power, I recommend that the Commission order SCE&G to expand its RTP
10 offerings to more industrial load. If industrial consumers feel that the RTP rates
11 are attractive, they may expand plant production thereby lessening the excess
12 power now on the SCE&G system.

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VII. SUMMARY

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4 **Q. MR. O'DONNELL, PLEASE SUMMARIZE YOUR TESTIMONY.**

5 A. In the current proceeding, SCE&G is seeking a base rate increase of \$151.5
6 million. Unfortunately for the Company and even more so for its ratepayers, the
7 Company already has some of the highest electric rates in the Southeast. These
8 high rates threaten the economic viability of the manufacturing industry in South
9 Carolina and all associated jobs within the SCE&G territory. With natural gas
10 prices at the current low levels, SCE&G is at a very real risk of losing
11 manufacturing load to plant closings or self-generation.

12

13 The return on equity requested by the Company in this proceeding is excessive
14 and unreasonable. In addition, the capital structure of SCE&G has been double-
15 leveraged thereby forcing captive ratepayers to pay inflated returns to the
16 Company. My recommendation is that the return on equity (ROE) be set at
17 9.50% and the Commission employ the SCANA Corp. capital structure of June
18 30, 2012 for ratemaking purposes.

19

20 I also recommend the following accounting adjustments:

- 21 • the Company should bear 50% of the net revenue loss associated with the
- 22 terminated wholesale power contract;
- 23 • all employee incentive pay should be eliminated;
- 24 • the Company should not be allowed recovery of EEI dues;
- 25 • SCE&G's request for placing the pension deferral in rate base should be
- 26 disallowed; and

1 • the Company's request for additions to its storm reserve fund should be
2 disallowed.

3

4 If the Commission accepts all my recommendations in this proceeding, the
5 Company will be allowed to raise its base rate revenue requirements by \$38.25
6 million in this case. My specific rate recommendation is the increase the spread
7 amongst all customer classes in the same proportions initially proposed by the
8 Company in its application.

9

10 My last recommendation is that the Commission accept the Company's proposed
11 fuel cost decrease as prescribed by the Company in this proceeding.

12

13 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**

14 A. Yes.